STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE ENROLLED BILL ANALYSIS

Date Amended:	**Enrolled**	Bill No:	**AB 3073**
Tax:	**Property**	Author:	**Assembly Revenue and Taxation Committee**
Related Bills:	**AB 3075 (AR&T)**		

BILL SUMMARY

This bill would, with respect to property taxes, (1) expressly provide that limited liability companies may qualify for the welfare exemption, and (2) improve the administration of base year value transfers provisions for contaminated property and allow for inflation adjustments in the equal or lesser than value comparison.

SECTION 1
LIMITED LIABILITY COMPANIES

Current Law

Current law provides for a "welfare exemption" under which property is exempt from property taxation if it is used exclusively for religious, hospital, scientific, or charitable purposes, and it is owned and operated by funds, foundations, or corporations meeting numerous statutory requirements.

The welfare exemption is created by Article XIII, Section 4, which authorizes the Legislature to exempt property used exclusively for religious, hospital, or charitable purposes and owned or held in trust by corporations or **other entities**. In implementing this provision, the Legislature has specified in Revenue and Taxation Code Section 214 that the "**other entities**" include "community chests, funds (or) foundations."

Proposed Law

This bill would amend various provisions of the welfare exemption to expressly add limited liability companies as an eligible "other entity" if they qualify for exemption. It would also require the Board of Equalization (Board) to adopt regulations to specify the ownership, organizational, and operational requirements for a limited liability company to qualify for the welfare exemption.

In General

Welfare Exemption. Under Section 4(b) of Article XIII of the California Constitution, the Legislature has the authority to exempt property (1) used exclusively for religious, hospital, or charitable purposes, and (2) owned or held in trust by nonprofit organizations operating for those purposes. This exemption from property taxation, popularly known as the *welfare exemption*, was first adopted by voters as a Constitutional Amendment on November 7, 1944. With this amendment, California became the last of 48 states in the country to provide such an exemption from property taxes. The ballot language in favor of the amendment stated:

> These nonprofit organizations assist the people by providing important health, citizenship and welfare services. They are financed in whole or in part by your contributions either directly or through a Community Chest. It is good public policy to encourage such private agencies by exemption rather than to continue to penalize and discourage them by heavy taxation.

When the Legislature enacted Section 214 of the Revenue and Taxation Code to implement the Constitutional provision in 1945, a fourth purpose, *scientific*, was added to the three mentioned in the Constitution. Section 214 parallels and expands upon the Constitutional provision by exempting property used exclusively for the stated purposes (religious, hospital, scientific, or charitable), owned by qualifying nonprofit organizations if certain requirements are met. An organization's *primary* purpose must be either religious, hospital, scientific, or charitable. Whether its operations are for one of these purposes is determined by its activities. A qualifying organization's property may be exempted fully or partially from property taxes, depending on how much of the property is used for qualifying purposes and activities. Section 214 is the primary welfare exemption statute in a statutory scheme that consists of more than 20 additional provisions. Over the years, the scope of the welfare exemption has been expanded by both legislation and numerous judicial decisions.

Owned and Operated Requirement. Section 214 requires that, to be eligible for the welfare exemption, both the owner and the user of a property must meet specific requirements. The first step in determining welfare exemption eligibility is to determine if the organization itself qualifies. In brief, an organization must meet the following requirements:

- It must be organized and operated for exempt purposes;
- It must not be organized or operated for profit;
- The owner organization must have an Internal Revenue Code (IRC) §501(c)(3) or Revenue and Taxation Code 23701d letter of exemption;
- The user organization may also qualify with an IRC §501(c)(4) or Revenue and Taxation Code §23701f or §23701w letter;
- The organization's earnings must not benefit any private shareholder or individual;
- Articles of Incorporation must contain an acceptable statement of irrevocable dedication of the property to exempt purposes;
- Articles must contain an acceptable Dissolution Clause; and
- The property owner must be the owner of record on the lien date.

Where there are different owners and operators, property is not eligible for exemption unless the **owner and operator** meet the specific requirements of Section 214. An operator is a user of the property on a regular basis, with or without a lease agreement. Typically, the owner and operator are one and the same and the filing of one claim for exemption will suffice. However, it is not necessary that the owner and the operator of the property be the same legal entity. If property is owned by one exempt organization and operated by another exempt organization, each must qualify and file a claim for exemption. If the operator is not an exempt organization, the welfare exemption is not available on the property.

Specific Requirements for Use of Property. The Constitution and statutes impose a number of requirements that must be met before property can become eligible for exemption. Nonprofit organizations claiming exemption for their properties must satisfy various organizational requirements and must meet additional requirements that govern the uses of their property. With respect to the use of the property:

- The property must be used exclusively for exempt purposes.
- The property must be used for the actual operation of an exempt activity.[1]
- The property is not to be used to benefit any person through distribution of profits, compensation or the more advantageous pursuit of his or her business or profession.

COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by Board Member John Chiang to provide nonprofit organizations that currently qualify for the welfare exemption the option of forming limited liability companies for purposes of owning and operating their properties.

2. **Amendments.** The June 28 amendment makes these provisions operative on January 1, 2005. The June 15 amendment added these provisions which were previously included in AB 3075 (AR&T).

3. **Many nonprofit organizations have approached the Board investigating the possibility of reforming as an LLC.** Under current law and regulations, ownership by a limited liability company (LLC) is not expressly provided, even if it is wholly owned by qualifying nonprofit organizations. Board staff has responded to those inquiring that existing property tax law and regulations would not permit the welfare exemption to be extended to property owned by an LLC and that a modification of existing laws and/or regulations would be necessary to expressly provide for LLCs.

4. **Other Entities.** Section 214 implements Section 4(b) of Article XIII of the California Constitution, which provides that the Legislature may exempt, “property used exclusively for religious, hospital or charitable purposes and owned or held in trust by corporations or other entities" that meet certain requirements. The original language in the Constitution identified the nonprofit organizations as “community chests, funds, foundations or corporations,” recognizing the types of nonprofit entities in existence at that time. These entities also have been specified in Section 214 since its enactment in 1945. Subsequent amendment to the Constitution however, replaced this language with more general language, “corporations or other entities.” The intent of the Constitutional amendment in 1945 was to allow exemption from property taxes to all nonprofit organizations providing services to the community and meeting the specified requirements. Thus, amending Section 214 to expressly include LLCs would update the statutory provision and achieve consistency with voter intent in approving the original Constitutional Amendment.

[1] The exemption is limited to the amount of property reasonably necessary for the accomplishment of the exempt purpose. Portions of the property in excess of that reasonably necessary for the purposes of the organization do not meet the requirements for property tax exemption and are subject to taxation.

5. **Rule Petition.** In May 2003, a petition was filed with the Board to adopt a new regulation (Property Tax Rule 136) that would extend the welfare exemption to a LLC organized and operated for exempt purposes. In response, the Board began a series of interested parties meetings and developed a regulation and a companion legislative proposal that would allow LLCs wholly owned by nonprofit tax exempt organizations to qualify for the welfare exemption. A group of interested parties, including assessors and tax attorneys, worked in July and August of 2003 to reach consensus on the proposed legislation and regulation. The Board authorized publication of the proposed regulation in October 2003 and a public hearing was held on May 25, 2004. On June 30, 2004, the Board adopted the proposed regulation with an amendment that defines "qualifying organizations" to include governmental entities. The regulation, as amended, would allow a nonprofit limited liability company jointly owned by a nonprofit tax-exempt organization and a government entity to qualify its property for exemption.
6. **Pending Rule.** The regulation's provisions define a qualifying LLC for purposes of Section 214 as one that is wholly owned by one or more qualifying nonprofit organizations, or co-owned by a nonprofit organization and a governmental entity. The proposed regulation enumerates organizational and operational requirements intended to ensure that qualifying LLCs adhere to the same requirements as other nonprofit [tax-exempt] entities currently eligible for the exemption. The corresponding statutory changes that this bill makes would add the LLC as a qualifying entity in Section 214 et seq., thereby allowing the LLC and its property to qualify for the exemption only if all the existing requirements for the welfare exemption are satisfied. The rule language is available at http://www.boe.ca.gov/regs/regscont.htm.
7. **The enactment of the bill and the companion regulation should not cause an expansion of the exemption, but instead authorizes a change in the type of legal entity qualifying for exemption.** Under the proposed regulation, the LLC must be wholly owned by qualifying nonprofit tax-exempt organizations or co-owned by a qualifying nonprofit tax-exempt organization that is eligible for the welfare exemption and a governmental entity. Both the LLC and its property must satisfy the same legal requirements as other legal entities eligible for the welfare exemption. Thus, nonprofit organizations already receiving the welfare exemption for their real property would have the option of transferring these assets to a qualifying LLC, as specified in proposed Rule 136. The addition of governmental entities as qualifying organizations does not cause an expansion of the exemption since governmental property is already exempt from property taxation. (Article XIII, Section 3)

SECTION 2
CONTAMINATED PROPERTY

Current Law

Section 69.4 and Section 74.7 of the Revenue and Taxation Code implement Proposition 1 of November 1998 to provide one of two possible types of property tax relief to property owners who unknowingly purchase contaminated property. Property owners may either transfer their base year value of the contaminated property to a replacement property or may rebuild their property after the land contamination is cleaned up and receive a new construction exclusion. Under either option, the property owner may retain their prior level of taxation under Proposition 13.

Chapter 941, Statutes of 1999 (SB 1231), added Section 69.4 to the Revenue and Taxation Code to provide the necessary Legislative implementation of the constitutional amendment. Since many of the specific conditions and limitations are detailed in the constitutional language, the statutory language related to base year value transfers is brief.

Proposed Law

Certain elements are currently lacking in the statutory language for counties to evaluate whether a replacement property qualifies for the base year value transfer. This bill would amend Section 69.4 to address the following issues:

VALUE COMPARISON CRITERIA. Section 69.5 provides that "equal or lesser value" means that the full cash value of the replacement property at the time of its purchase must be 105% or less of the full cash value of the sold property if purchased in the *first* year following the sale of the original property, and 110% or less if purchased in the *second* year following the sale. Section 69.3 provides thresholds of 105% in the first year, 110% in the second year, and 115% in the third year. Section 69.4 is silent as to permitting an inflation adjustment for purposes of the equal or lesser value requirement.

Proposition 1 provides that the replacement property be acquired within 5 years. Following precedents set in Sections 69.3 and 69.5, this bill would amend Section 69.4 to specify value thresholds that step up from 105% in the first year following acquisition of the replacement property to 125% in the fifth year following such acquisition. This would give affected property owners some protection from being disqualified as a consequence of inflation.

COMPARABILITY. The Legislative Analyst stated in the ballot pamphlet describing Proposition 1 that "[t]he replacement property could involve either (1) the repair or reconstruction of a damaged structure on the contaminated site or (2) purchase of a *similar* structure on a different site." (Emphasis added.) In addition, the "Argument in Favor of Proposition 1" discussed how innocent homeowners who are victims of environmental disasters could receive relief for a replacement home under this constitutional amendment. Consequently, this bill would provide that property purchased as a replacement for contaminated property must be similar or comparable to the property being replaced.

REQUESTING RELIEF. This bill would specify that the Board prescribe a form to claim the base year value transfer. It would also detail the information on the claim, as specified by Proposition 1, that a taxpayer would be required to provide on the claim in order to receive relief. In addition, a three-year time limit for requesting relief would be instituted to be consistent with other provisions of law authorizing transfers of base year value.

Background

On November 3, 1998, the voters of California approved Proposition 1, adding subdivision (i) to Section 2 of Article XIII A of the California Constitution. Upon implementation by the Legislature, this amendment allows one of two forms of property tax relief for qualified contaminated property. Specifically, property owners are able to choose from either of the following:

1. They may sell or otherwise transfer the qualified contaminated property and transfer its base year value to a replacement property of equal or lesser value. The

replacement property must be acquired or newly constructed within five years after the sale or transfer of the qualified contaminated property. The replacement property may be located in a different county than the qualified contaminated property, only if the county in which the replacement property is located, has passed a resolution accepting such base year value transfers.

2. If structures located on the qualified contaminated property are substantially damaged or destroyed in the course of the remediation of the environmental problems, the repair or replacement of such structures may be excluded from the definition of "new construction" provided that the repaired or replacement structure is similar in size, utility, and function to the original structure.

This relief applies to replacement property that is acquired or newly constructed on or after January 1, 1995, and to property repairs performed on or after that date.

COMMENTS

1. **Sponsor and purpose.** This provision is sponsored by Board Member John Chiang. Its purpose is to improve the administration of base year value transfers under Section 69.4 and to protect taxpayers from being disqualified under the equal or less than value test due to the lack of an inflation adjustment over the five year period allowed to obtain a replacement property.
2. **Amendments.** The June 15 amendment added these provisions which were previously included in AB 3075 (AR&T).

COST ESTIMATE

The Board would incur insignificant costs (less than $10,000) in informing and advising county assessors, the public, and staff of the change in law.

REVENUE ESTIMATE

SECTION 1
Limited Liability Companies

Current property tax law provides for a welfare exemption under which property is exempt from taxation if that property is used exclusively for religious, hospital, scientific, or charitable purposes, and that property is owned and operated by funds, foundations, or corporations meeting statutory requirements. As of September 30, 1994, the Corporations Code has authorized the formation of limited liability companies (LLCs) (Beverly-Killea Limited Liability Act (Stats, 1994, Ch. 1200, SB 469). Under both state and federal income tax law, an LLC may be treated as an entity that is not separate from its owner ("disregarded entity"); i.e., the assets of the LLC are treated as being owned directly by its parent nonprofit organization.

However, state property tax law does not allow this treatment for purposes of the welfare exemption. Under current property tax law, 1) the LLC is treated as an entity separate from its owner and the LLC, not the parent nonprofit organization, must qualify for the exemption; and 2) the statute enumerates certain types of entities eligible for the welfare exemption, and an LLC is not specifically listed as one of those entities.

Under this bill, an LLC that is wholly owned by qualifying nonprofit organization(s) organized and operated exclusively for religious, hospital, scientific, or charitable purposes, that are exempt from federal or state income tax, or jointly owned by a nonprofit organization and a governmental entity, may qualify for the welfare exemption. There would not be a revenue impact for those properties that currently qualify for the welfare exemption, as the properties are already owned by qualifying exempt organizations. Thus, if the nonprofit owner transferred the properties to a qualifying LLC as a result of this bill, only the method of holding title to the properties would change. Assuming there is an existing LLC wholly owned by qualifying nonprofit organization(s) that meets all the legal requirements for exemption, there would be a revenue impact for the property that currently does not qualify for exemption, but may under this bill. On the other hand, an LLC organized and operated for profit would not qualify for exemption as a result of this bill, and it most likely would not convert to a nonprofit LLC due to the profit motive/investments of its member(s)/owners. Under this scenario, the LLC members would be required to donate their ownership interest in the for-profit LLC to the nonprofit LLC, foregoing their investment and any profit.

With respect to an LLC jointly owned by a nonprofit organization and a governmental entity, there would not be a revenue loss since the property of the nonprofit entity would already qualify for exemption and government property is already exempt under state law.

In the last few years, several claims for the welfare exemption have been denied because the properties in each case were owned and operated by a limited liability company. In nearly all of these cases, the LLCs apparently were not wholly owned by qualifying nonprofit organizations, or the owner would have opted to transfer the property to a nonprofit entity eligible to receive the welfare exemption. For example, three properties previously owned by a qualified nonprofit corporation in San Bernardino County, had qualified for exemption in prior years, but subsequently were transferred to an LLC owned by the nonprofit. The LLC ownership caused disqualification from the exemption for about a year, but the properties were transferred back to the nonprofit corporation and can qualify for the exemption on the 2004-05 roll. Under this bill, such properties could qualify for the exemption without the nonprofit owner transferring the properties from an LLC to a qualifying type of entity, since the LLC would be wholly owned by the nonprofit.

Based on information provided by various county assessors, we are aware of four properties in the state that have been denied the welfare exemption because an LLC owns the properties. The total assessed value of these properties amounts to $20.6 million. However, none of these properties would qualify for exemption under this bill because the LLC is not wholly owned by qualifying nonprofit organizations or because the LLC no longer exists.

Moreover, no exemption claims have been filed with the Board of Equalization and/or assessors by existing LLCs in California that claims nonprofit status independently of their parent nonprofit organization. Thus, the number of currently taxable properties that would be potentially affected under this bill is therefore very small.

This bill probably will have no revenue impact, but a minimal revenue impact cannot be ruled out entirely, since it is possible that a few properties may be owned by existing LLCs that have not previously claimed the exemption, and might qualify for exemption under this bill. Therefore, there is a slight possibility that this bill may have a limited revenue impact of less than $100,000 per year.

Qualifying Remarks

In general, an LLC representative requesting welfare exemption forms would have been informed by county assessors and Board staff that LLCs were not eligible for the welfare exemption. Therefore, no claim forms would have been filed and subsequently denied.

SECTION 2

Contaminated Property

This bill would expressly define the phrase "equal or lesser value" for purposes of special base year value provisions.

The revenue effect is difficult to pinpoint due to the lack of predictability of the factors involved, specifically, which properties would be affected, and differences between the fair market values of the qualified contaminated properties and the replacement properties. Since it is likely that only a few properties would be affected by this bill, any revenue impact will be very small.

The provisions clarifying the phrase "equal or lesser value" of replacement property of qualified contaminated property will have no significant revenue impact.

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